Supreme Court, U.S.
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No. 02-1367

In the Supreme Court of the United States

ROBERT R. EUSTACE, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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10 pp

QUESTION PRESENTED

Whether the expenses that petitioners incurred in developing computer software for sale to customers qualify for the income tax credit provided for "qualified research expenses" under Section 41(a) of the Internal Revenue Code, 26 U.S.C. 41(a).

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-6a) is reported at 312 F.3d 905. The opinion of the Tax Court (Pet. App. 7a-22a) is reported at 81 T.C.M. (CCH) 1370.

JURISDICTION

The judgment of the court of appeals was entered on December 13, 2002. On March 13, 2003, Justice Stevens extended the time within which to file a petition for a writ of certiorari to and including April 14, 2003. The petition was filed on March 13, 2003. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Applied Systems, Inc., is a Subchapter S corporation that developed and improved software products for sale to independent insurance agencies during the years involved in this case (1990-1992). Pet. App. 1a, 10a-16a. Petitioners are the shareholders of that corporation. On their income tax returns for those years, petitioners claimed that the tax credit provided by Section 41(a) of the Internal Revenue Code for "qualified research expenses" applies to the software development expenses incurred by Applied Systems. 26 U.S.C. 41(a).[1] The Internal Revenue Service, however, determined that this research tax credit is not available for those software development expenses. Petitioners thereafter brought this suit in Tax Court to challenge the Commissioner's determination. Pet. App. 16a-17a.

2. The Tax Court agreed with the Commissioner that the research tax credit of Section 41(a) is not available on the facts of this case. Pet. App. 7a-22a. The court concluded that "qualified research" under this statute must be "research that is undertaken to discover information that goes beyond the current state of knowledge in the computer science field." *Id.* at 17a. No such research was undertaken by Applied Systems in developing the software programs involved in this case. *Id.* at 21a. The court also noted that the statute specifies that only research undertaken through a "process of experimentation" may qualify for the credit (26 U.S.C. 41(d)(1)(C)) and that "simply debugging a computer program" does not represent a "process of

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[1] The items of income and loss and the deductions and tax credits of a Subchapter S corporation generally flow through to its shareholders and are reported by the shareholders on their income tax returns. 26 U.S.C. 1366(a).

experimentation." Pet. App. 18a (quoting *United Stationers, Inc.* v. *United States*, 163 F.3d 440, 445 (7th Cir. 1998), cert. denied, 527 U.S. 1023 (1999)).

The court held that, on the record of this case (Pet. App. 21a):

> Petitioners fell woefully short of presenting sufficient evidence to establish, as required by section 41, that Applied Systems' activities met the requirements for the research credit. Applied Systems did not undertake research to discover information beyond the current state of knowledge in the computer science field. Nor did Applied Systems conduct a process of experimentation aimed at eliminating uncertainty about the technical ability to develop the software.

3. The court of appeals affirmed. Pet. App. 1a-6a. The court concluded that "[t]he evidence at trial in the Tax Court shows that Applied Systems engaged in normal software development" and that "[n]one of it was pioneering; all of it entailed variations on themes long used by other developers." *Id.* at 2a. For the reasons already twice articulated by that court in *Wicor, Inc.* v. *United States*, 263 F.3d 659 (7th Cir. 2001), and *United Stationers, Inc.* v. *United States*, 163 F.3d at 444-446, the court held here that the mere industrious development of software through a process of trial-and-error does not constitute "qualified research" under Section 41(a). Pet. App. 3a. The court of appeals also noted (*id.* at 4a-5a) that these routine software development activities would not constitute "qualified research" under the slightly different articulation of the same statutory standards in the decision of the Tenth Circuit in *Tax & Accounting Software Corp.* v. *United*

States, 301 F.3d 1254 (2002), petition for cert. pending, No. 02-1291.

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Further review is therefore not warranted.

1. This case presents the same question presented in *Tax and Accounting Software Corporation* v. *United States*, No. 02-1291. For the reasons set forth in our brief in opposition to the petition for a writ of certiorari in that case, the petition in this case should also be denied.[2]

2. Petitioners seek to raise additional claims that were not presented in the *Tax and Accounting Software Corp.* case. In particular, petitioners assert (Pet. 13, 28-29) that they have unfairly been denied the benefit of proposed regulations issued by the Treasury for public comment on December 26, 2001. 66 Fed. Reg. 66,362. Those proposed regulations have not been adopted as final regulations and, of course, they remain subject to modification or withdrawal at any time before their final adoption. See *Telecom*USA, Inc.* v. *United States*, 192 F.3d 1068, 1080 (D.C. Cir. 1999), cert. denied, 529 U.S. 1123 (2000); *Teweleit* v. *Hartford Life & Accident Ins. Co.*, 43 F.3d 1005, 1009 (5th Cir. 1995); *In re Appletree Markets, Inc.*, 19 F.3d 969, 973 (5th Cir. 1994) ("proposed regulations are not entitled to judicial deference"); *Garvey, Inc.* v. *United States*, 726 F.2d 1569, 1571-1572 (Fed. Cir.), cert. denied, 469 U.S. 823 (1984). Moreover, petitioners cannot claim that they

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[2] We are providing to petitioners herewith a copy of the government's brief in opposition to the petition for a writ of certiorari in *Tax and Accounting Software Corp.*, No. 02-1291.

took any action in reliance on the proposed regulations, for the expenditures involved in this case were incurred many years before the proposed regulations were issued.[3]

3. Petitioners err in asserting (Pet. 20) that the decision in this case conflicts with the decision of the Tenth Circuit in *Tax and Accounting Software Corp.*, *supra*. As the court of appeals explained in this case, although the Tenth Circuit articulated slightly different standards in evaluating a claim of "qualified research" in the *Tax and Accounting Software Corp.* case, petitioners "cannot meet the[] definitions" of the statutory terms in that case "any more than" they can meet the standards applied by the Seventh Circuit in this case. Pet. App. 4a-5a. See note 3, *supra*.

The slightly different wording applied by these two circuits in their consistent rejection of identical claims for a "research" tax credit for software development expenses plainly would not alter or affect the result in any of the cases that have been brought in either circuit. The slightly different description of the statutory standards in these cases therefore does not warrant review by this Court. This Court "reviews judgments,

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[3] Petitioners also err in contending that the proposed regulations would "not replace any earlier ones" (Pet. 18). If the proposed regulations issued in December 2001 are at some point adopted, they would replace or amend the current final regulations, which were adopted after public notice and comment on January 3, 2001. T.D. 8930, 2001-1 C.B. 433, 440, 449. The final regulations adopted in January 2001 set forth an interpretation of the "discovery" test under Section 41(a) that is consistent with the interpretation applied by the court in this case (Pet. App. 3a)(the discovery must "expand or refine existing principles") and by the Tenth Circuit in *Tax and Accounting Software Corp.*, 301 F.3d at 1261 (the discovery must be of "something new or previously unknown").

not statements in opinions" (*Black* v. *Cutter Laboratories*, 351 U.S. 292, 297 (1956)) and does not "decide questions that cannot affect the rights of litigants in the case before them." *Lewis* v. *Continental Bank Corp.*, 494 U.S. 472, 477 (1990) (quoting *North Carolina* v. *Rice*, 404 U.S. 244, 246 (1971)).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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